Unveiling DG ECFIN Thinking On Competitiveness

Ronald Janssen, *Social Europe Journal*, 05/03/2014

This Wednesday, the Commission will publish its new series of country in-depth studies with the aim of identifying those member states in danger of suffering from an excessive macroeconomic imbalance. The novelty here is that Germany as an economy recording huge external surpluses will also be examined by the Commission.

Whether the Commission will seize this opportunity to support more robust wage growth in Germany (for example by calling for the introduction of a minimum wage without having so many exceptions that the principle of installing a general wage floor is undermined from the very start) remains to be seen. It is more likely that the Commission will instead continue to push Germany into further deregulation of its economy, hoping that in particular the opening up of the services sector would provide a boost to domestic demand and reduce Germany's gigantic net export surplus.

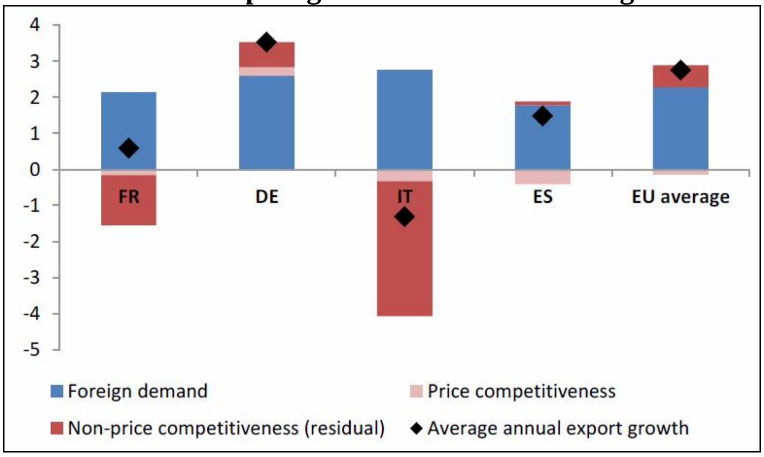
Irrespective of the outcome of this in-depth study on Germany, it is enlightening to look at the way German economic policy has been evaluated in the past by DG ECFIN. Indeed, even if no separate country study was published on Germany, the 2012 and 2013 in-depth reviews on France provide valuable insights into Commission thinking since economic policy in France and Germany are systematically compared with each other.

It's quality, not costs that matter….

In fact, the Commission has a bit of a problem here. In the past, DG ECFIN has repeatedly published research concluding that the record export performance of Germany has in fact little to do with price competitiveness, thereby casting serious doubts over the strategy of wage stagnation Germany has been following over the major part of the past decade.

This finding is summarized in the following graph taken from the 2012 imbalances report on France. It shows that price competitiveness only played a very small, almost to be ignored, role in explaining export performance of manufactured goods over the entire 1999 – 2009 period. Instead, export dynamics are to be explained by growth in export markets and non-price competitiveness. The latter is estimated as a residual and refers to the quality of the goods being produced, their level of sophistication and complexity, the efforts in terms of research and development and the ability of firms to engage in exports. As can be seen from the graph, non-price competitiveness has contributed positively to export dynamics of Germany while dragging export growth of France down.

Contributions to export growth in manufactured goods



%, 1999-2009

However, this finding is completely at odds with the policy of internal wage devaluation that is actively being promoted by the Commission across major parts of Europe, stating that to improve competitiveness, wages and wage formation systems need to become extremely flexible.

Redefining non-price competitiveness as wage competitiveness

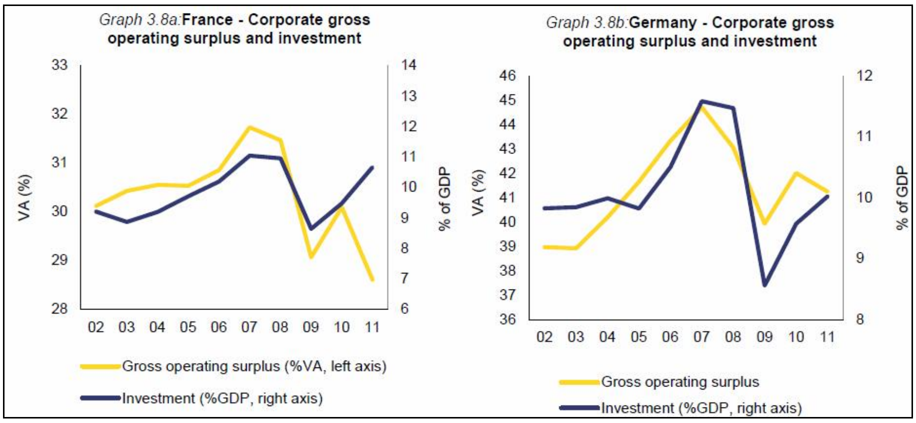
DG ECFIN is aware of this contradiction and addresses it by writing in the 2013 French economy review that: "*Beyond the apparent opposition between the two approaches, cost and non-price competitiveness actually complement one another*". (page 29)

This, rather bold, statement is then further explained by referring to the developments in Germany. According to DG ECFIN, the story is that a decade of wage stagnation in Germany has 'significantly and durably' restored profit margins, thereby providing business the financial means to invest in innovation and in new and modern productive capacities. Or as DG ECFIN writes: "*The reduction of production costs (…) translated into the recovery in investment from 2005 that has led to their spectacular increasing performances in competitiveness*". (page 35)

This argument is then further backed up by two graphs, supposedly showing that profits and investment for the corporate sector are strongly linked (see below). These graphs convey the image that investment dynamics in Germany have intensely reacted to the significant increase in profit margins, whereas profit and investment developments in France have been rather dismal.

In short, and paraphrasing the old German saying that today's wage moderation represents investment and the jobs in the future, DG ECFIN's view is that the wage cuts of today result in the innovation of tomorrow.

This means we are back to square one. Critical voices warning against the effects of the whole of Europe engaging in competitive wage moderation or saying that Europe cannot compete against China on the basis of low wages are in this way being told to shut up since the Commission is claiming wage stagnation will anyway benefit non-price competitiveness.



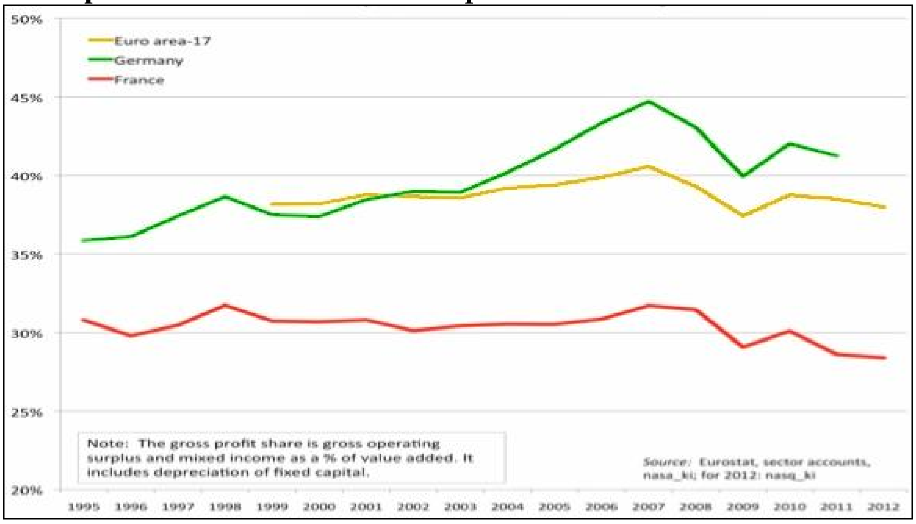
A closer look

There is however an optical illusion at work in the Commission's graphs. Notice how the scale of the vertical axis is different in the two graphs. This helps to suggest that the increase in corporate investment has been very and much more pronounced in Germany compared to France between 2004 and 2008. In fact, looking closer at the exact figures reveals that the improvement in investment performance of French corporations was actually a little bit better and improved by 2pp of GDP over this period whereas the increase in corporate investment as a % of GDP was limited to 1.5pp in Germany.

Moreover, the Commission's graphs are comparing 'apples and oranges'. They net out the gross operating surplus as a percentage of the total amount of added value by the corporate sector against corporate investment as a share of the GDP of the total economy. The next two graphs provide a more correct picture. They also show longer term developments, since the mid-nineties.

From the first graph it follows that corporate profit margins in Germany have seen a significant trend increase from the end of the nineties to 2010/2011, thereby surpassing the average for the Euro Area. In France on the other hand, corporate sector profit margins have remained rather stable, at a level lower than the German or the Euro area average one.

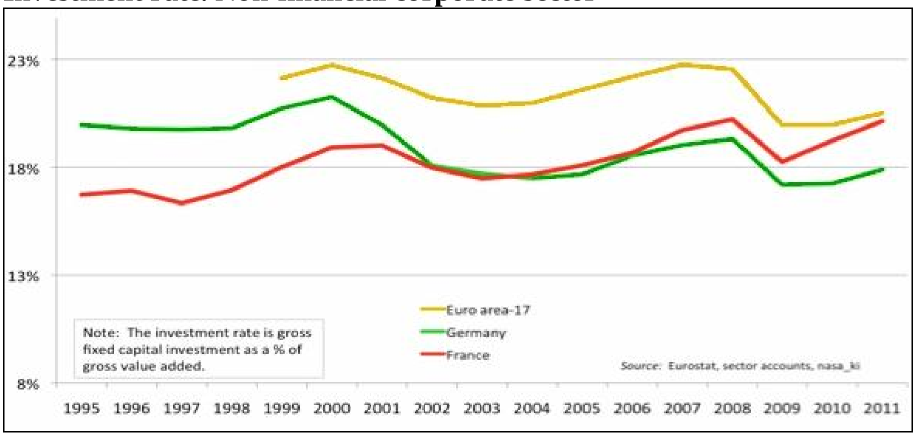
Gross profit share. Non-financial corporations



Is the outstanding performance of profit margins in Germany being reflected in outstanding business investment? The answer is no. In fact, as can be seen from the next graph, it is actually the contrary. The trend increase in business profits in Germany has been accompanied by a trend fall in business investment. At the end of the nineties, the share of business investment in corporate added value was actually higher in Germany than in France. German business investment then fell towards the French level in the early 2000's and has basically stayed there since then, and this despite the boost in corporate profit margins.

Meanwhile, corporate investment in France did not suffer from a decrease in investment over the business cycle. This has led French business to outperform German business investment in most recent years.

Investment rate. Non-financial corporate sector



Keeping up appearances

DG ECFIN seems to be aware that it finds itself on rather shaky grounds. Indeed, even if the message to the wider public is that the Commission text is filled with all sorts of caveats such as:

Restoration of profit margins MAY have contributed to fostering investment and innovation (…) *A reduction in taxes on labour CAN have a positive impact on non-price competitiveness* (…) *INSOFAR as it allows companies to build non price competitiveness, an improvement of cost competitiveness WOULD have a positive long term impact.*

These wordings in capital letters may satisfy the Commission services' desire to safeguard its intellectual reputation. Meanwhile, however, the message to the wider public and formal policy-makers is clear: Nevermind the lack of evidence, the benefits of wage flexibility are undisputable or so the Commission claims.